

TABLE I-9. CURRENT INDICATORS OF BUSINESS FIXED INVESTMENT AND SURVEYS OF CAPITAL SPENDING PLANS FOR 1987

	1984	1985	1985				1986		
			I	II	III	IV	I	II	III
Current Indicators									
Nondefense Capital Goods Orders (billions of dollars per month)	26.9	27.2	26.8	26.3	27.8	27.8	26.5	26.2	27.3
Manufacturers' Capital Appropriations (billions of dollars, quarterly rate) a/	29.4	27.2	29.9	27.6	24.2	27.2	23.4	20.0	20.2
Capacity Utilization (percent)	81.0	80.4	80.7	80.5	80.3	80.2	80.0	79.2	79.1
Corporate Economic Profits (billions of dollars, annual rate) b/	265	281	266	274	296	286	296	293	302
Corporate Net Cash Flow (billions of dollars, annual rate) c/	345	375	361	372	389	380	391	386	390
Corporate AAA Bond Rate (percent)	12.7	11.4	12.3	11.6	11.0	10.6	9.6	9.0	8.8
Standard and Poor's 500 Stock Index (annual percent change)	0.0	16.4	32.7	18.0	7.8	19.7	55.5	43.1	1.0
Surveys of Capital Spending Plans for 1987 (In percents)									
			Nominal		Real				
Department of Commerce d/			0.9		0.2				
McGraw-Hill e/			0.4		-3.1				

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; McGraw-Hill, Inc.; Conference Board; Federal Reserve Board.

- Because of the seasonal adjustment, the annual figure does not equal the average of the quarterly figures.
- Economic profits are adjusted for inventory valuation and capital consumption allowances.
- Net cash flow equals corporate retained earnings with inventory valuation adjustment, plus economic depreciation.
- Conducted in October and November 1986.
- Conducted in September and October 1986.

Inventories

Changing petroleum prices and the incentive programs for auto purchases caused large quarter-to-quarter swings in nonfarm business inventories in 1986. In general, though, the rate of accumulation was slightly below the rate of growth of final sales. High real interest rates and the low rate of inflation in commodity and producer prices may have discouraged inventory accumulation. The downtrend in the inventory-to-sales ratio could also have been caused in part by the foreign trade deficit, since manufacturers' inventories declined over the year even as wholesale and retail trade inventories were being built up. By contrast, U.S. stocks of petroleum and petroleum products increased sharply, apparently in anticipation of higher prices and greater demand.

Although real short-term interest rates are expected to fall, and the projected turnaround in the trade balance will probably be accompanied by rising inventories for manufacturers, the relatively slow growth in final sales will hold down inventory growth. In addition, petroleum inventories will probably not match their 1986 growth, and auto manufacturers will probably keep inventories leaner this year to avoid having to repeat costly incentive programs. In short, nonfarm business inventories are expected to increase by about the same amount in 1987 as last year.

Residential Construction

After flirting with an annual rate of 2 million units in early 1986, housing starts slumped at midyear and continued to slow throughout the second half, though for the year as a whole they remained above 1985 levels. The slowdown was evident in both single-family and multifamily starts as different factors combined to buffet both ends of the market.

Single-family units, which are more directly affected by demand factors, held up very well early in the year because of declining mortgage rates and gains in personal income. Declines in real personal disposable income in the third quarter of last year, and a leveling off of the decline in mortgage rates in the last half of the year, reduced the pace of new home sales, however. With the inventory of new homes growing, builders quickly reduced the number of new starts. More recent data indicate that the slowdown in the single-family market has bottomed out. With interest rates expected to remain relatively stable and real disposable income expected to grow modestly over the rest of this year, single-family starts in 1987 should fall only slightly below the 1986 average.

While demand factors influenced the market for single-family homes, changes in the tax laws and rapidly rising rates of rental vacancies caused a sharp decline in the number of multifamily starts. Apparently, the bulge in this sector that occurred early in 1986 was in anticipation that changes in the tax code would limit tax shelters. Once those changes became law, multifamily starts dropped precipitously. Moreover, with vacancy rates higher than at any time since the late 1960s, it may take some time to absorb the oversupply. Thus, 1987 may be a year of continued weakness in this sector.

Net Exports

Real net exports proved to be weaker in 1986 than previously anticipated. Though exports appeared to be recovering in the second half of the year, the volume of imported nonoil merchandise grew faster than real GNP for most of 1986, and those imports slowed overall real growth.

Given the dollar depreciation since the first quarter of 1985, the rate of increase in prices of nonoil merchandise imports continued to be low until the second quarter of 1986. This may have been part of the reason imports grew more than they were expected to. Major foreign exporters and U.S. distributors of imported goods probably absorbed a significant proportion of the dollar's depreciation against some currencies by maintaining profit margins that are low relative to levels when the dollar was very strong. Moreover, the average depreciation of the dollar against the currencies of major suppliers of U.S. imports was much lower than its average decline against the currencies of major industrial countries (see Box I-1).

The volume of exports of nonagricultural merchandise was weak through midyear, but rose substantially in the third quarter. The November trade report indicated, however, that growth of exports in the fourth quarter may not be as strong as anticipated.

Many observers predicted a surge in U.S. agricultural exports following the dramatic decline in U.S. support prices (loan rates) last summer. Despite the drop in support prices, hopes of much higher agricultural exports for the 1986 crop year were dashed by good harvests in the Soviet Union and elsewhere, and because foreign producers protected their market shares by matching the decline in U.S. prices. Agricultural exports did increase significantly in the third quarter, but only by enough to offset purchases delayed earlier when foreigners waited for the preannounced price declines.

Factors Underlying the Outlook for Net Exports. The dollar exchange rate continues to be the crucial factor influencing the outlook for net exports.

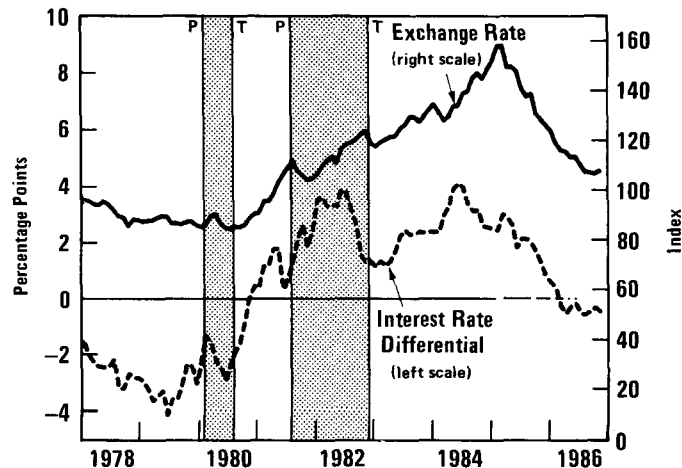
During the second half of 1986, the value of the dollar continued to fall relative to the currencies of other industrial countries despite foreign intervention in its support, as reflected in a rapid accumulation of dollar reserve assets by foreign monetary authorities. By the fourth quarter, the average value of the dollar (as measured by the Federal Reserve Board index based on the currencies of 10 major industrial countries) was about 32 percent below its peak in the first quarter of 1985.

The increase in purchases of dollar assets by foreign governments coincided with an apparent weakening of demand for dollars by international private investors. Net private capital flows (total inflows minus total outflows) fell in the first three quarters of 1986, compared with the same period in 1985.

The relative weakness in underlying international private demand for U.S. dollars is the result of the sluggish performance of the U.S. economy and a relatively accommodative U.S. monetary policy. While monetary conditions have also been mildly expansionary in most other major industrial economies, and both short- and long-term interest rates abroad have declined, foreign interest rates have declined more slowly than have U.S. rates. The resulting differences in interest rates favor, on average, other major currencies as investment vehicles. Both nominal and real (inflation-adjusted) short-term interest rates for the United States are lower than their average foreign counterparts, and both nominal and real long-term interest rates have moved against the dollar recently (see Figure I-16).

Figure I-16.
The Exchange Rate
and Relative
Interest Rates

SOURCES: Congressional Budget Office; Federal Reserve Board; International Monetary Fund.



NOTE: The exchange rate is a trade-weighted average of dollar exchange rates. The real interest-rate differential is the difference between long-term real interest rates for the United States and a GDP-weighted average for other industrial countries. Long-term real interest rates are long-term nominal interest rates (on government bonds), adjusted for expected inflation rates. Expected inflation is proxied by a two-year centered moving average of actual and projected CPI inflation rates.

The Congressional Budget Office assumes that the value of the dollar relative to the currencies of major foreign industrial countries will decline over the forecast period, but at a slower rate than in the past year. If international private demand for dollars weakens further (or if foreign monetary authorities curtail the rate of accumulation of dollar assets), the dollar will probably depreciate more sharply than CBO assumes. On the other hand, if there is sufficient firming of U.S. interest rates and if monetary conditions abroad become sufficiently relaxed, the dollar exchange rate against major currencies may stabilize.

Movements in the dollar exchange rates vis-a-vis the currencies of Latin America and the countries of the Pacific Rim are also very important to the outlook for net exports because these countries are major U.S. trading partners and competitors. The value of the dollar relative to these currencies continued to rise on an inflation-adjusted basis in 1985 and 1986, even as its value declined against the currencies of the 10 industrial countries included in the Federal Reserve Board exchange-rate index. CBO assumes a moderate decline over the forecast period in the real value of the dollar relative to the currencies of the most important developing countries. As explained in the accompanying box, however, the uncertainty attached to this assumption is large for a variety of political and economic reasons. Thus, the outlook for a significant proportion of U.S. imports--and the relative competitiveness of U.S. exports--remains highly uncertain.

The outlook for net exports depends also on expected inflation and real growth among U.S. trading partners. Inflation in the major industrial economies of Europe, Canada, and Japan is expected to remain very low over the next couple of years, because of movements in exchange rates and continued weakness in primary commodity prices. The major foreign industrial economies are expected to maintain an average real growth rate of 2.5 percent to 3.0 percent per year despite expected weakening of their real net exports and continued or strengthened restraint in government fiscal policies. Inflation in the newly industrialized countries (NICs) of Asia is expected to remain moderate, but average inflation in Latin America is forecast to remain very high and volatile. Thus, the outlook for inflation in the developing countries is a substantial contributor to the uncertainty of real exchange rates mentioned previously. Largely because of low growth among the fuel exporters, the average real growth rate was low in 1986 for the developing countries that are important to U.S. exports. But this growth rate is expected to move well above the 3 percent level in coming years.

The Outlook for Net Exports. Exports of nonagricultural merchandise should provide a strong stimulus to U.S. real growth in each year of the forecast.

BOX I-1 THE EXCHANGE VALUES OF THE DOLLAR

The value of the dollar reached its peak in the first quarter of 1985. How much it has depreciated since then varies according to which exchange-rate index is used. One commonly used measure is the Federal Reserve Board exchange-rate index, which comprises currencies of 10 major industrial countries weighted in proportion to their respective shares in world trade. According to that index, the dollar, in real (inflation-adjusted) terms, depreciated by 31 percent between the first quarter of 1985 and the third quarter of 1986.

The exchange rate can also be measured against the currencies in the Federal Reserve Board index plus the currencies of developing countries and newly industrialized countries (NICs), with two variations in the weighting scheme. If the weighting scheme continues to reflect shares in world trade--as is important for measuring the competitiveness of U.S. exports in world markets--then the real depreciation of the dollar is significantly lower, at 23 percent. But if the currencies are weighted to reflect bilateral nonoil imports--giving much greater weight to major import suppliers such as Canada--then the real depreciation of the dollar is lower still, at only 16 percent.

Measured against only the currencies of developing countries and NICs, the dollar actually appreciated in real terms by between 5 percent and 8 percent and was virtually flat against the Asian NIC currencies alone (those of Hong Kong, Singapore, South Korea, and Taiwan). Thus, the Asian NIC currencies depreciated in real terms against the European currencies and the yen by about the same percentage as the U.S. dollar. The depreciation of their currencies sharply improved their competitive position, as reflected in their increased exports, to both Europe and the United States. Rather than allowing the bulging trade surpluses to cause their currencies to appreciate, monetary authorities of the Asian NICs chose to step up the accumulation of dollar assets. Their resistance to appreciation of their respective currencies is manifested both in high rates of growth in their money supply and in very large additions to their official holdings of foreign exchange reserves. Recently, some Asian NICs have been subject to growing external political pressures to appreciate their currencies. If they do not succumb to these pressures, the Asian NICs eventually may suffer a severe bout of domestic inflation that would appreciate their currencies against the U.S. dollar in real terms.

The real value of the dollar has appreciated substantially against the currencies of developing countries largely because of a massive devaluation of the Mexican peso. Some Latin American countries plan further devaluations to counter domestic inflation, which is exceptionally high. It is very difficult, however, to keep adjustments in exchange rates and domestic inflation in balance. Thus, the future real value of the dollar in relation to the currencies of developing and newly industrialized countries is subject to considerable uncertainty on the up side as well as the down side.

As argued previously, however, the strong downside and upside risks that are attached to the assumed exchange rates make this a particularly uncertain projection. If the newly industrialized countries of Asia are able to prevent real appreciation of their currencies, they could provide strong competition to future U.S. sales of nonagricultural merchandise in the European and Japanese markets. Real agricultural exports are not expected to make a significant contribution to the growth in real GNP in 1987 and 1988.

Although the November trade release indicates a further worsening of the merchandise trade deficit in the last quarter of 1986, CBO forecasts a decline in the rate of growth of real imports of nonoil merchandise in both 1987 and 1988. The volume of petroleum imports should decline in early 1987, as domestic oil refiners adjust to the accumulation of relatively large stocks and higher prices this winter (following the recent OPEC production agreement) and the possibility of lower prices next spring and summer.

Although the real net balance on service flows other than investment income is very small, it is expected to improve in 1987 and 1988. On the other hand, flows of net investment income, on a National Income and Product Accounts (NIPA) basis, fell in real terms during the second quarter of 1986. Although they rose in the third quarter of the year, they are expected to fall in real terms over the entire forecast period, as the growth of U.S. holdings of foreign assets relative to foreign holdings in the United States declines. U.S. net foreign liabilities could reach half a trillion dollars by the end of 1988.

Government Purchases

The public sector contributed to the growth of aggregate demand during the second and third quarters of 1986, as real purchases by the federal, state, and local governments rose at an annual rate of 9.7 percent. In contrast, spending in this sector is expected to grow more slowly than GNP throughout most of the forecast period.

The Federal Sector. On a National Income and Product Accounts basis, real federal purchases (excluding the activities of the Commodity Credit Corporation) grew very rapidly during the second and third quarters of 1986 (see Table I-10). This strong growth was entirely attributable to a surge in defense purchases (both durables and nondurables) that more than offset a continuing decline in nondefense purchases. Under the deficit restrictions of the Balanced Budget Act of 1985, the level of federal purchases is projected to decline over the forecast period.

The State and Local Sector. Real purchases by state and local governments also showed very strong growth in the second and third quarters, reflecting near-record growth in construction spending. This surge in construction followed record borrowing by states and localities in the past two years. The level of spending for construction is expected to climb somewhat into next year, especially if the highway authorization bill is enacted soon. But, thereafter, construction activity is expected to decline. With slow to moderate growth in other purchases, the state and local sector will not be a source of stronger growth.

The operating surplus of state and local governments amounted to \$15.6 billion in the first quarter of 1986, \$3.9 billion in the second quarter,

TABLE I-10. GOVERNMENT PURCHASES OF GOODS AND SERVICES
(By calendar year, on a national income accounting basis)

	1984	1985	1985		1986		
			III	IV	I	II	III
Billions of 1982 Dollars							
Federal <u>a/</u>	293.9	311.3	318.4	314.9	314.0	324.4	333.4
Defense	219.4	235.8	242.2	239.3	238.7	249.3	259.4
Nondefense <u>a/</u>	74.4	75.6	76.1	75.6	75.3	75.0	74.0
State and Local	383.5	397.6	401.9	402.2	404.8	413.3	419.5
Structures	45.1	48.2	51.0	48.5	48.7	54.9	58.5
All other	338.4	349.4	350.9	353.7	356.1	358.4	361.0
Percent Change (annual rate)							
Federal <u>a/</u>	5.3	5.9	12.2	-4.3	-1.0	13.9	11.6
Defense	6.0	7.5	15.8	-4.7	-1.0	19.0	17.2
Nondefense <u>a/</u>	2.8	1.6	1.1	-2.6	-1.6	-1.6	-5.2
State and Local	2.6	3.7	5.1	0.3	2.6	8.7	6.1
Structures	5.1	6.9	19.3	-18.2	1.7	61.5	28.9
All other	2.2	3.3	3.3	3.2	2.7	2.6	2.9

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

a. Excludes purchases and sales by the Commodity Credit Corporation.

and \$8.3 billion in the third. The large surplus in the first quarter included a special nonrecurring receipt of \$8.2 billion (from fines against Exxon); in the third quarter, states received a \$2.7 billion acceleration of the final payment for general revenue sharing from the fourth quarter. CBO forecasts a swing to small operating deficits for state and local governments in 1987, as grants-in-aid are reduced and a greater proportion of construction spending is financed by debt. Although most states with income taxes stand to reap windfall revenues from the Tax Reform Act of 1986, this windfall will do little to improve the operating balances in this sector, particularly since many of these states are considering passing this windfall through to their taxpayers. At the same time, surpluses in state and local trust funds are expected to continue growing, but more slowly than in recent years. As a result, the overall budget surpluses of this sector will provide less of an offset to federal borrowing.

CHAPTER II

THE BUDGET OUTLOOK

The Congressional Budget Office projects that the baseline federal deficit will fall from \$221 billion in fiscal year 1986 to \$174 billion in 1987, \$169 billion in 1988, and \$85 billion in 1992. The deficit shrinks because revenues are boosted by both inflation and real economic growth, while outlays rise only slightly faster than the rate of inflation. Compared with the size of the nation's economy, the baseline deficit falls from 5.3 percent of gross national product (GNP) in 1986 to 4.0 percent in 1987 and 1.4 percent in 1992. While the federal debt will continue to grow as long as the government runs deficits, the debt is projected to reach a plateau of about 44 percent of GNP in the 1988-1990 period. Table II-1 summarizes the CBO baseline projections for total federal revenues, outlays, and the deficit, including off-budget items.

Although baseline deficits are declining, they still substantially exceed the targets established by the Balanced Budget Act, as pictured in Figure II-1. The 1988 deficit would have to be cut \$61 billion below the baseline to reach the legislated goal of \$108 billion. If these deficit reductions are not enacted before August 15--and the target is not changed--the Congress will be faced with voting on large across-the-board spending reductions. The calculation of these spending reductions is based on a deficit measure that differs from the CBO baseline, as explained in Box II-1.

The projections are based on the CBO short-run economic forecast and long-run economic assumptions described in the previous chapter. The baseline projections also assume that current taxing and spending policies will continue unchanged through the five-year projection period. Defense and nondefense discretionary appropriations are assumed to be held constant in real terms; revenues, offsetting receipts, and entitlement spending are projected according to the laws now on the statute books. The baseline projections are, therefore, not forecasts of future federal budgets, since those budgets will doubtless include numerous policy changes. They are, however, a benchmark against which proposed policy changes can be measured. Appendix A provides further details on how current budgetary policy is defined for purposes of the baseline projections.

The projected drop in the deficit is almost \$50 billion from 1986 to 1987--much greater than in any later year. Roughly half of this decline stems from one-time factors. First, the Tax Reform Act of 1986 (Public Law 99-514) increases 1987 revenues by \$12 billion compared with prior tax law; in 1988, however, it reduces revenues by \$2 billion. Second, the Omnibus Budget Reconciliation Act of 1986 (Public Law 99-509) provides for the sale of federal physical and financial assets (including loan prepayments) totaling about \$8 billion in fiscal year 1987. Third, releasing offshore oil and gas receipts held in escrow and delaying September 30, 1987, military pay checks by one day together reduce 1987 outlays by about \$4 billion. Were any of the asset sales to be postponed, the 1987 deficit could prove to be higher than the current estimate and the 1988 deficit correspondingly lower.

TABLE II-1. CBO BASELINE PROJECTIONS
(By fiscal year)

	1986 Actual	1987 Base	Projections				
			1988	1989	1990	1991	1992
In Billions of Dollars							
Revenues	769	834	900	962	1,050	1,138	1,220
Outlays	990	1,008	1,069	1,124	1,184	1,247	1,305
Deficit	221	174	169	162	134	109	85
Balanced Budget Act Target	172	144	108	72	36	0	---
Debt Held by the Public	1,746	1,910	2,077	2,236	2,367	2,473	2,556
As a Percent of GNP							
Revenues	18.5	19.0	19.2	19.1	19.4	19.6	19.7
Outlays	23.8	22.9	22.8	22.3	21.9	21.5	21.1
Deficit	5.3	4.0	3.6	3.2	2.5	1.9	1.4
Debt Held by the Public	41.9	43.4	44.2	44.4	43.8	42.7	41.3
Reference: GNP (In billions of dollars)	4,163	4,399	4,698	5,033	5,406	5,792	6,186

SOURCE: Congressional Budget Office.

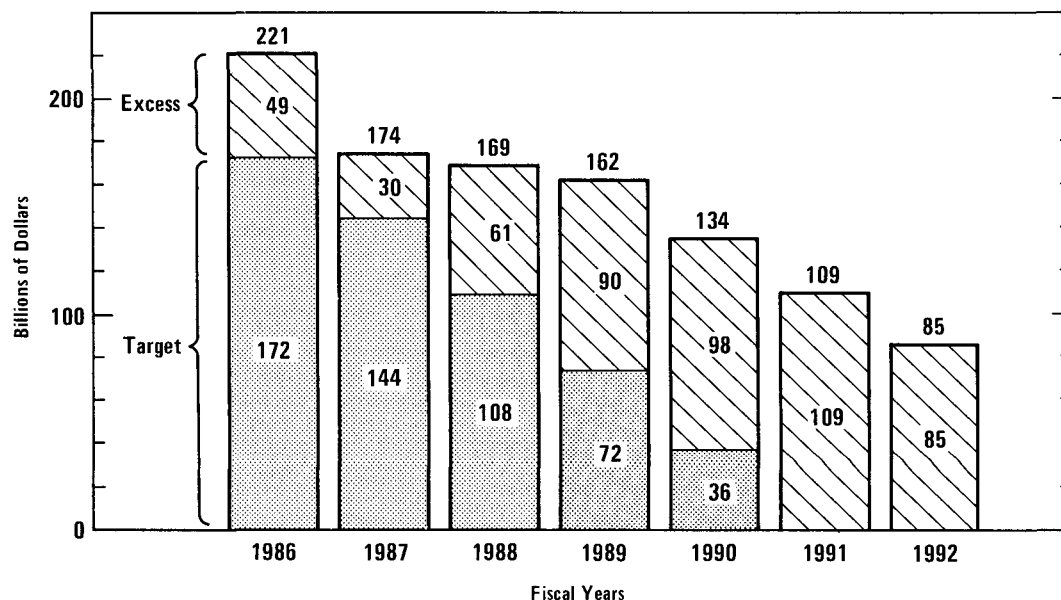
NOTE: Totals include Social Security, which is off-budget.

Even aside from such special circumstances, budget projections are highly uncertain. If the economy were to move along the low-growth or high-growth paths described in the previous chapter, the 1988 baseline deficit could be as high as \$266 billion or as low as \$131 billion. Technical changes in tax and spending patterns might also have a substantial effect on the deficit projections. For example, unforeseen increases in farm price supports, Medicare and Medicaid, unemployment insurance, and other spending programs, as well as technical adjustments to revenues, have increased the 1988 baseline deficit estimate by \$17 billion since CBO's last report, as discussed in the next section. In recent years, errors in technical assumptions have caused the estimates in the first Congressional budget resolutions to differ from the actual deficits by an average of \$17 billion. Appendix D provides further details on the sources of differences between actual budget totals and first budget resolution estimates.

This chapter focuses on total federal government fiscal activities, including the two Social Security trust funds, which were moved off-budget in 1985. The total federal deficit provides a better measure of the economic significance of federal government activities than does the on-budget deficit alone. Moreover, the estimated total deficit is used in calculating the excess deficit for purposes of the Balanced Budget Act.

Figure II-1.

CBO Baseline Deficit Projections



SOURCE: Congressional Budget Office.

BOX II-1 SPENDING REDUCTIONS UNDER THE BALANCED BUDGET ACT

The Balanced Budget Act establishes a series of declining deficit targets, culminating in a balanced budget in fiscal year 1991. The deficit target for 1988 is \$108 billion. Under the fallback provisions of the act, the Congress will consider across-the-board spending cuts under highly expedited procedures if CBO and the Office of Management and Budget (OMB) estimate that the 1988 base deficit exceeds the target by more than \$10 billion. The initial CBO-OMB report is due on August 20.

The budget base specified in the Balanced Budget Act differs somewhat from the CBO baseline. If appropriations for fiscal year 1988 have not been enacted five days or more before the reporting date, the law provides that the outlay base assume appropriations at the 1987 dollar level, without allowing for inflation or other adjustments. The law also provides that the outlay base assume pay raises for federal military and civilian employees as recommended by the President, which differs somewhat from the CBO baseline assumptions.

CBO currently estimates that the base deficit for a possible 1988 sequestration is \$158 billion. Eliminating the \$50 billion excess deficit would require across-the-board reductions in budgetary resources of 14 percent for defense programs and 20 percent for nondefense programs. The figures in the August report will be averages of CBO and OMB estimates and will take account of new legislation, changes in the economy, and other developments affecting the budget outlook.

	(In billions of dollars)		
	Revenues	Outlays	Deficit
CBO Baseline Projection	900	1,069	169
Differences			
Exclusion of discretionary inflation and other adjustments to 1987 appropriations			
Defense programs	---	-5	-5
Nondefense programs	---	-6	-6
Adjustment in net interest costs	---	a/	a/
Total differences	---	-11	-11
Base for Balanced Budget Act	900	1,058	158

a. Less than \$500 million.

While the total deficit is projected to decline, this decline masks substantially different trends in the on-budget and off-budget activities, as shown in Table II-2. The on-budget deficit is projected to grow from \$193 billion in 1987 to \$208 billion in 1989 and then to taper down to \$160 billion by 1992. On the other hand, the off-budget Social Security trust funds are running a surplus, which is projected to grow from \$19 billion in 1987 to \$75 billion in 1992. These surpluses reflect increases in Social Security tax rates scheduled for 1988 and 1990, which are intended both to restore the trust fund balances to a level that would allow benefit payments to continue even in a major economic downturn and to provide adequate long-run financing for the program. By the end of the projections period, the balances in the Social Security trust funds will represent nearly one year's benefit outlays.

TABLE II-2. CBO BASELINE PROJECTIONS FOR ON-BUDGET AND OFF-BUDGET SPENDING AND REVENUES
(By fiscal year, in billions of dollars)

	1986	1987	1988	1989	1990	1991	1992
Baseline Revenues							
On-budget	569	620	660	700	764	828	889
Off-budget							
(OASDI) ^{a/}	<u>200</u>	<u>214</u>	<u>241</u>	<u>262</u>	<u>287</u>	<u>310</u>	<u>331</u>
Total	<u>769</u>	<u>834</u>	<u>900</u>	<u>962</u>	<u>1,050</u>	<u>1,138</u>	<u>1,220</u>
Baseline Outlays							
On-budget	806	814	865	908	956	1,004	1,049
Off-budget							
(OASDI) ^{a/}	<u>183</u>	<u>195</u>	<u>205</u>	<u>216</u>	<u>229</u>	<u>243</u>	<u>256</u>
Total	<u>990</u>	<u>1,008</u>	<u>1,069</u>	<u>1,124</u>	<u>1,184</u>	<u>1,247</u>	<u>1,305</u>
Baseline Deficit (-) or Surplus							
On-budget	-237	-193	-205	-208	-192	-176	-160
Off-budget							
(OASDI) ^{a/}	<u>17</u>	<u>19</u>	<u>36</u>	<u>46</u>	<u>58</u>	<u>67</u>	<u>75</u>
Total	<u>-221</u>	<u>-174</u>	<u>-169</u>	<u>-162</u>	<u>-134</u>	<u>-109</u>	<u>-85</u>

SOURCE: Congressional Budget Office.

a. OASDI = Old-Age, Survivors, and Disability Insurance.

CHANGES IN BASELINE BUDGET PROJECTIONS SINCE AUGUST 1986

Since CBO last published its budget projections in August 1986, several major laws have been enacted. These include the Tax Reform Act of 1986, the Omnibus Budget Reconciliation Act of 1986, and a continuing resolution making appropriations for fiscal year 1987 (Public Law 99-591). Compared with the August baseline, this newly enacted legislation reduced the deficit by \$32 billion in 1987, as shown in Table II-3. Because most of the savings were one time, however, legislative action decreased the deficit by an average of only \$6 billion in 1988 through 1991. Under CBO's August economic and technical assumptions, Congressional action would have reduced the 1987 deficit to about \$151 billion--within \$10 billion of the Balanced Budget Act target. But CBO's new economic and technical assumptions raise the 1987 deficit estimate by \$23 billion--to \$174 billion.

Revised economic assumptions add to the deficit by amounts growing from \$10 billion in 1987 to \$25 billion in 1991. Lower levels of nominal GNP and changes in the composition of national income cause estimated revenues to be lower by \$13 billion in 1987 and \$22 billion in 1991. Lower projected interest rates, however, reduce debt service outlays and somewhat attenuate the budgetary effect of the lower revenues.

Technical reestimates, primarily to spending, increase the projected deficit substantially in all years. Medicaid and Medicare spending in 1986 exceeded expectations; this growth is expected to continue, adding \$3 billion to spending in 1987 and \$7 billion by 1991, compared with the August projections. Changes in the outlook for U.S. agricultural exports, the Administration's establishment of a paid diversion program for feed grains, and other factors increase outlays for farm price supports by \$3 billion in 1987 and about \$6 billion per year in the 1988-1991 period. Revised defense spending estimates add less than \$1 billion to 1987 outlays but about \$3 billion per year thereafter. Projected outlays have also risen by an average of \$1.5 billion annually for unemployment compensation and \$1 billion per year for assistance payments and supplemental security income, reflecting recent spending experience. Finally, based on spending plans of the Federal Deposit Insurance Corporation (FDIC) and of the Federal Savings and Loan Insurance Corporation (FSLIC), estimated federal assistance to troubled financial institutions is projected to grow by more than \$4 billion in 1987.

BUDGET PROJECTIONS UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS

Federal government revenues, spending, and the deficit are strongly influenced by economic conditions. Budget projections are, therefore, highly

TABLE II-3. CHANGES FROM CBO AUGUST BASELINE
PROJECTIONS (By fiscal year, in billions of dollars)

	1987	1988	1989	1990	1991
Revenues					
CBO August Baseline	828	915	987	1,067	1,148
Enacted legislation	17	6	-3	4	8
Revised economic assumptions	-13	-18	-22	-21	-22
Technical reestimates	<u>2</u>	<u>-2</u>	<u>a/</u>	<u>1</u>	<u>3</u>
Updated Baseline	834	900	962	1,050	1,138
Outlays					
CBO August Baseline	1,012	1,065	1,113	1,162	1,217
Enacted legislation	-15	-4	-3	<u>a/</u>	-2
Revised economic assumptions	-4	-7	-6	-3	3
Technical reestimates	<u>16</u>	<u>15</u>	<u>20</u>	<u>25</u>	<u>28</u>
Updated Baseline	1,008	1,069	1,124	1,184	1,247
Deficit					
CBO August Baseline	184	150	127	96	69
Enacted legislation	-32	-9	<u>a/</u>	-5	-10
Revised economic assumptions	10	11	15	19	25
Technical reestimates	<u>13</u>	<u>17</u>	<u>20</u>	<u>24</u>	<u>25</u>
Updated Baseline	174	169	162	134	109

SOURCE: Congressional Budget Office.

NOTE: Totals include Social Security, which is off-budget.

a. Less than \$500 million.

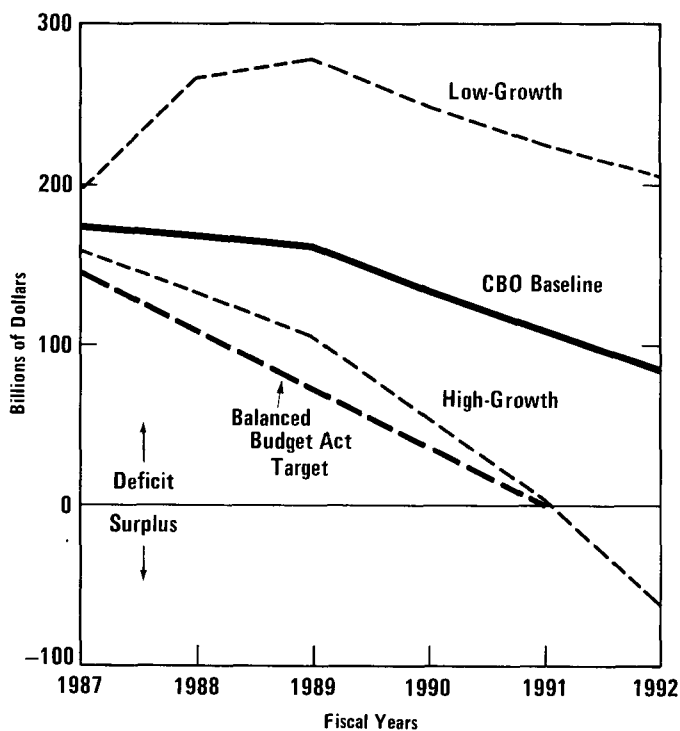
sensitive to the economic assumptions on which they are based. This section illustrates in two ways how the economy affects the budget. First, it shows how the baseline deficit projections would differ under the high-growth and low-growth economic assumptions, summarized earlier in Table I-4. These high-growth and low-growth paths are designed to illustrate the range of possible future economic developments and mirror typical interactions among various aspects of the economy. Second, this section provides some rules of thumb for gauging the budgetary effects of changes in individual economic variables.

High-Growth and Low-Growth Alternatives

The high-growth path is characterized not only by more rapid real economic growth but also by greater inflation than the baseline assumptions. Interest rates are slightly lower during the first two years of the projection period but higher thereafter. The low-growth path assumes a recession in 1987 that is similar in depth and duration to the recession of 1973 to 1975; the assumed recovery is average by postwar standards. Table II-4 compares the budget projections under the baseline and the two alternatives.

Not surprisingly, the high-growth assumptions reduce the projected deficit, so that the 1988 deficit would be \$131 billion--\$38 billion below the

Figure II-2.
Federal Deficit Under
Alternative Economic
Assumptions



SOURCE: Congressional Budget Office.

baseline. By 1992, the budget would actually show a surplus of \$63 billion under these assumptions, as pictured in Figure II-2. Revenues are consistently higher in the high-growth case than in the baseline. The difference is roughly proportional to the difference in nominal GNP, as additional real growth and inflation both add to taxable incomes. The ratio of revenues to GNP is slightly higher than in the baseline, because the boom economy raises business income as a share of GNP.

TABLE II-4. CBO BUDGET PROJECTIONS UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS (By fiscal year, in billions of dollars)

	1987	1988	1989	1990	1991	1992
Revenues						
High-Growth Alternative	848	930	1,013	1,133	1,274	1,441
CBO Baseline Projection	834	900	962	1,050	1,138	1,220
Low-Growth Alternative	816	828	860	937	1,008	1,071
Outlays						
High-Growth Alternative	1,006	1,062	1,117	1,188	1,277	1,378
CBO Baseline Projection	1,008	1,069	1,124	1,184	1,247	1,305
Low-Growth Alternative	1,015	1,094	1,138	1,185	1,233	1,275
Deficit						
High-Growth Alternative	158	131	104	55	3	-63 <u>a/</u>
CBO Baseline Projection	174	169	162	134	109	85
Low-Growth Alternative	199	266	278	248	225	204

SOURCE: Congressional Budget Office.

NOTE: Totals include Social Security, which is off-budget.

a. Surplus

The pattern of outlay differences is more complex. Because higher growth brings higher inflation, outlays for benefit programs, such as Social Security, are higher than in the baseline. Defense and nondefense discretionary spending, which the baseline holds constant in real terms, are also higher. Initially, these inflationary increases are small and are more than offset by lower spending on unemployment-sensitive programs (primarily unemployment compensation) and on net interest. Net interest outlays are at first below the baseline, then above it, mirroring the differences in interest rates. In total, outlays in the high-growth path are within a few billion dollars of the baseline amounts in 1987 through 1990 but greatly exceed the baseline in 1991 and 1992, when all categories of spending are substantially higher.

In the low-growth path, the deficit remains above \$200 billion throughout the projection period. Revenues are much lower than the baseline every year, although they are only slightly lower in relation to GNP. Outlays grow more rapidly at first, as spending increases for programs that are sensitive to the higher unemployment and interest rates; they fall below the baseline in the last two years in response to the lower rate of inflation.

Social Security trust fund surpluses and balances continue to grow throughout the projection period under both the high-growth and low-growth assumptions. In the high-growth case, trust fund balances at the beginning of 1992 represent 100 percent of 1992 outlays--slightly above the 94 percent ratio achieved under the baseline economic assumptions. In the low-growth case, however, the trust fund ratio is only 67 percent. The low-growth alternative has a less adverse effect on Social Security than the 1973-1975 and 1980 recessions because, unlike those earlier recessions, it is not characterized by falling real wages.

Rules of Thumb

While the use of consistent alternative forecasts is one way to illustrate the sensitivity of the budget to the economy, the same point may be made in a different fashion. Table II-5 provides some rough orders of magnitude for gauging the effects on the baseline projections of changes in individual economic variables considered in isolation. It illustrates the budgetary effects of a one percentage-point change beginning January 1987 for four variables: real economic growth, unemployment, interest rates, and inflation.

Two rules of thumb--higher real growth and lower unemployment--are closely related. Both paths illustrate the effects of different assumptions